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SUBJECT: SCENESETTER FOR SECRETARY SNOW'S VISIT TO INDIA

Classified By: AMBASSADOR DAVID C. MULFORD, REASONS 1.4 B,D

11. (C) Mr. Secretary, I want to warmly welcome you to India, a vibrant, diverse, multi-ethnic, multifaceted democracy -- much like our own in important respects -- that is emerging as an economic powerhouse and has growing global ambitions. Your visit will help set the stage for President Bush's trip to India next year. It will advance the President's directive to add depth and breadth to our bilateral relations, which have strengthened on virtually every front during the last four years. Your public message should be that you have come engage in a conversation with the Indian Government, Indian business and the Indian people about India's role in the international economy at the onset of the 21st century.

A STRATEGIC PARTNERSHIP

12. (C) Your visit follows an extremely successful visit to Washington by Prime Minister Manmohan Singh in July, when the release of the Joint U.S.-India Statement signaled an historic turning point in our bilateral relationship. Although the civil nuclear component received the most public attention, the Joint Statement goes far beyond that. In it, the two countries pledge to a partnership to address global and regional challenges for decades to come. We agreed to work together to work for democracy and economic growth around the world. We agreed to revitalize the Economic Dialogue, cooperate in the fields of education, agriculture, science and technology, and space launch. The Joint Statement confirms our growing commitment to work together across the whole range of activities that comprise human endeavor. We are now cooperating in the health sector, particularly in HIV prevention. We have a new and promising security relationship, in which topics such as interoperability of our militaries and defense coproduction are being openly discussed. In sum, we have a truly comprehensive, across the board engagement, which promises to be the foundation of one of our closest international partnerships in the decades ahead.

13. (C) American interests and Indian interests converge on a wide range of transnational issues -- terrorism, proliferation of WMD, illicit drugs, trafficking, promoting democracy in the world, and climate change. We have determined that the world would benefit if the two nations mobilize their military, political, and economic assets to address these challenges together as India emerges as a major power in the 21st century.

14. (C) India, too, has dramatically changed its policy towards the United States. On economic and commercial issues, the UPA government has moved incrementally on issues of importance to us: it has concluded an Open Skies policy; strengthened its IPR regime; taken steps to resolve our bilateral irritants; it has raised foreign direct investment limits in several sectors; and has lowered tariff rates in sectors of importance to our industry. A symbolic FDI legacy issue, the Dabhol dispute, which was complicated by the Enron collapse, was resolved by the GOI this July just prior to the Prime Minister's Washington visit. The state-controlled Air India has selected Boeing to supply \$9.5 billion worth of commercial aircraft.

15. (C) On the political front, it is clear that the GOI wants a closer relationship with us. From the early days of this UPA government's tenure, it has sent us public and private signals that it views its ties with the US as its most important international relationship. Prime Minister Manmohan Singh has taken considerable heat from his own party, his coalition partners, and the opposition for his decision to side with us against Iran at the IAEA last month. Our close coordination in responding to the Tsunami last year and to the ongoing Nepal crisis are other examples of increasing trust and cooperation between us on regional and international matters.

UNPRECEDENTED OPTIMISM

16. (C) In this context, your visit comes at a time of unprecedented optimism about the US-India relationship. Our

message to the Indian public that we want a strong and prosperous India will get heavy press play. You should highlight the benefits to be derived from a strategic partnership with the US as India emerges from its cold war, socialist past. You should underscore the U.S. commitment to a comprehensive partnership with India and highlight President Bush's directive to support India's efforts to become a global power. On other topics, we suggest you press the GOI to liberalize FDI in financial services sector, remove internal and external trade barriers, and accelerate economic reforms. In Delhi, you will be present at the signing of a bilateral agreement that allows USTDA to continue its activities to support Indian economic development and US trade and investment.

THE ECONOMIC DIALOGUE

17. (C) The U.S.-Indian economic partnership extends beyond trade and investment. The intensifying and increasingly complex economic links being forged between our two countries are having a profound impact on our respective economic outlooks in the 21st century. The principal tool we have used to strengthen the economic relationship is the US-India Economic Dialogue (ED). The ED is headed by Al Hubbard of the White House and Deputy Planning Commissioner Montek Ahluwalia, who is a close confidant of the Prime Minister. The goal of the ED to advance the President's directive to transform U.S.-Indian relations by revitalizing the U.S.-India economic and commercial relations.

18. (C) You last met with Chidambaram at the G-20 meeting in Beijing. We are pleased that you will be leading the engagement of the Financial and Economic Forum as it will enhance the effectiveness of the Economic Dialogue. In your bilaterals, you should reaffirm the USG commitment to the Dialogue and its Finance track, the Financial and Economic Forum.

CEO FORUM

19. (C) A new CEO Forum was established this July to advise policy makers on what is required to remove structural impediments to greater trade and investment ties. Both governments recognized that input from the business community is an integral component of a successful bilateral economic dialogue and agreed to create this high-level private sector forum to exchange business community views on key economic priorities. The CEO Forum, which first convened at the White House in the presence of President Bush and Prime Minister Manmohan Singh on July 19, is composed of 10 chief executives from each country. You will be meeting with the Indian CEOs of this group in Mumbai, where you should underscore the importance of the CEO forum and the USG commitment to take its views seriously.

110. (C) The CEOs represent a cross-section of industrial sectors, particularly those that have a stake in improving the commercial climate between our two countries. The CEO's collectively represent about a trillion dollars in capital. As the contributors of capital and bearers of risk, who have a global perspective, they have been tasked with identifying key issues and recommending a handful of high priority issues and measures that will enhance economic growth and employment in India and accelerate bilateral trade and investment. The CEOs Forum is working on a "CEO Forum's Key Policy Issues" document which they will present to President Bush and PM Singh during President Bush's planned visit to India next year.

ECONOMIC REFORMS AND COALITION MAINTENANCE

111. (C) In the US-India economic relationship, our most important priorities are continuation of economic reforms, redirecting uneconomic subsidies, and promoting financial market liberalization. Fifteen years of economic reforms have raised India's GDP growth to the 7-8 percent range, improved income levels, reduced poverty, and instilled increasing confidence within the country about its present and future international role. The quite visible benefits accruing from these reforms have created growing public support for more deregulation, liberalization and openness. This includes a whole new generation that is unencumbered by India's socialist decades. You should use your visit to congratulate the Prime Minister on his reform accomplishments to date and highlight our strong desire to use the U.S.-India Economic Dialogue to: resolve commercial disputes, identify and remove blockages to bilateral trade and investment, and increase private and government technical and regulatory exchanges.

112. (C) Successive Indian governments are moving these reforms forward, albeit within the political constraints imposed by India's vigorous and sometimes frustrating

democratic system. Analysts predict several decades of sustained robust economic growth, thanks in part to India's youthful population and its technical and scientific prowess. As India's largest trading partner and foreign investor, the Indians realize we are critical to their goals, which gives us considerable leverage in shaping their regional and global actions.

13. (C) Although the first generation of economic reforms has yielded good benefits for the country and its people, the second generation of reforms is encountering a stiff headwind. Even in the best of times, economic reforms in India are slow because they require a political consensus across a wide political spectrum before they can be implemented. Prime Minister Manmohan Singh and his economic team are finding it particularly difficult to move. They feel increasingly boxed in: on the left from their Communist coalition partners who have made a cottage industry out of opposing any reforms that the GOI proposes, including privatization, labor reform, and easing restrictions on FDI; on the right, from the BJP which never misses an opportunity to attack, even if the GOI's proposals are reforms that the BJP had originally proposed; and down its own middle, from the populist politicians in the Congress party itself, who are responsible for the budget-busting employment guarantee bill, and having tasted blood, this group feels emboldened to press for even more populist measures as it sees the party's electoral prospects stall or deteriorate in many key states.

14. (C) With this as a political backdrop, economic reforms will be implemented on an ad hoc basis. Issues that do not attract political flak, like opening up the civil aviation sector, reducing bureaucratic red tape and lowering tariffs and simplifying the tax code, will move forward. Agricultural reform, privatization and labor reform will encounter strong opposition, but to its credit, the GOI has at least opened up a public debate about these measures.

ECONOMY IS GOING STRONG ...

15. (C) The economy, led by manufacturing and services sector strength, started the fiscal year 2005-06 well, beating out most forecasts when growth accelerated to 8.1 percent in the April-June quarter. Growth in the agricultural sector, which accounts for 22 percent of GDP and supports 65 percent of the population, remained tepid, however. Projections are that growth for 2005-6 fiscal year will be in the 7-7.5 percent range. Key indicators point to continued economic growth and most analysts agree that over the medium and longer terms, Indian economic growth will be robust.

16. Inflation: Headline inflation seems subdued, currently at about 4.4 percent this year as compared to 6.4 percent last year. Inflation this year is expected to rise to the 5-5.5 percent range due to petroleum price hikes which are beginning to work themselves in the economy. The full impact of the oil price increases has been cushioned on the backs of the state-owned oil companies, which have not been allowed to pass on more than a minimal portion of the increases to consumers.

Interest Rates: After steadily declining for several years, interest rates have bottomed out. On October 27 the RBI hiked its repo and reverse rates by 0.25 percent to 6.25 and 5.25 percent, respectively, to address short-term inflationary pressures emanating from higher international oil prices and imports.

External Sector: Helped by the strong economy, imports from the US have surged 50 percent in the first quarter of 2005-6, with aviation equipment, electronic goods, machinery, transport equipment and scientific instruments among the biggest sellers. India's trade with the rest of the world has been increasing sharply as well. India could run up a current account deficit of nearly 3 percent of GDP this year, close to what many economists would regard as the 'danger zone'.

Rupee: After a 6% appreciation in the last 12 months, the rupee has begun to show distinct signs of weakening vis-à-vis the dollar. The rupee now ranges between Rs 44.5-45.4 to the dollar.

Foreign Exchange: India's foreign exchange reserves were \$143.3 billion on October 7 and have been steadily increasing since the balance of payments crisis in 1991 when India almost ran out of foreign exchange.

Foreign Direct Investment: While India's ability to attract FDI lags far behind China's, foreign investors are beginning to discover India. Foreign institutional investment alone is expected to top \$5 billion in 2005-06. As a result of strong FII inflows, FDI will likely exceed \$7 billion during the current fiscal year as compared to \$3.8 billion for the

previous year.

... BUT CLOUDS HOVER

17. (C) Fiscal Deficit: The chronic fiscal deficit headlines the macro-economic trouble spots. The combined federal-state deficit this year is expected to be 7.6 percent of GDP. Interest payments on government debt, which is estimated at 80 percent of GDP, consume nearly half the revenue received from taxes. The recently enacted plan to guarantee 100 days of work to every rural family will put an even greater strain on the country's fiscal performance.

Fiscal Reform: In April, several states implemented a VAT system to replace a complex web of indirect taxes. The VAT experiment has been highly successful, with an average increase of 16% in revenue collections by the VAT states. More states, including those governed by the opposition BJP are preparing to adopt VAT. While there is increasing debate about tax reform, the GOI efforts to broaden the tax base have not been very successful.

BANKING REFORM

18. (C) Earlier this year, the Reserve Bank of India (RBI) published a long-awaited "road map" for foreign banks in India. The rules place tight restrictions on the ability of foreign banks to take stakes in private sector Indian banks until at least 2009. Until then, foreign banks will only be allowed in most cases to grow "organically" via wholly-owned subsidiaries or a branch network, with severe restrictions on expansion. The roadmap promises to open up the market to large-scale foreign stakes in 2009. However, that horizon is too far away and probably too uncertain to mean anything for our contacts in the Indian banking sector. We and the CEOs of several large US financial institutions in New York and in India view the roadmap as a major step back and victory for the Communists and the RBI, and in particular its conservative Governor Y.V. Reddy and his "go-slow" to "move-back" approach to further FDI in the Indian banking sector. You should raise the issue in your meetings with Chidambaram, Ahluwalia, and RBI Governor Reddy.

19. (C) FM Chidambaram appears for the moment to be unwilling to take on Reddy. The institutional strength of the RBI would be difficult to overcome, particularly with the left on whom the government is dependent having openly expressed their opposition to any more liberal FDI policy toward foreign involvement in the banking sector or consolidation within the domestic sector. We may not have heard the last of the road map issue, although at this point in time we are not optimistic that there will be forward movement anytime soon. The tensions between the MOF and the RBI are well known. The MOF scored two important victories over the RBI in the past year: it pulled the RBI back from its plans to reduce current FDI limits in banking to 5 percent, and the Finance Minister quickly put Governor Reddy in his place after Reddy had suggested imposing a tax to limit FII inflows.

INFRASTRUCTURE

20. (C) One factor that may stymie India's growth prospects is its failure to develop a world class transportation infrastructure. Indian airports, road, railways, and ports are wholly inadequate to sustain the country's competitiveness in the global market place and threaten to thwart the country's aspirations of becoming a global economic and political power. Successive governments have recognized this but failed due to inadequate political leadership. Ambitious plans have been drawn up in the past, but they have languished due to failure to mobilize the resources, lack of clarity of purpose, and poor implementation. Nor is the problem just one of lack of funds. The problem has been a culture that intrinsically believes that it is the responsibility of government to plan, build, and operate these projects.

21. (C) India's capital markets are not sophisticated enough to channel or mobilize resources to fund large projects. India also lacks a culture of private project finance. There is no market for long term debt. The GOI needs to stimulate the creation of such capital markets by allowing an increase in the number and types of financial players. There are signs that the UPA government has learned the lessons of the past and will do things differently. Prime Minister Manmohan Singh has made infrastructure one of his government's top priorities, and announced the goal of attracting \$150 billion in foreign direct investment to the sector. A government run by economists appears to understand the vital role of the private sector in infrastructure development but needs help in creating appropriate incentives. Singh's government has signaled its intention to build public-private partnerships

in developing these projects. On the other hand, the government's negative attitude on liberalization of FDI caps for insurance companies and pension managers does not bode well for development any time soon of markets for long term financing or for large scale, long term public private project. It is an open question whether India will be able to break from the habits of the past and address what everyone in the society, except the Left, believes is a pressing need.

Conclusion

122. (C) In sum, you will come to India at a time when the President's goal of establishing a key strategic relationship is becoming a reality. Your visit will move us forward in building new habits of collaboration with one of the world's rising giants. My team looks forward to welcoming you to India and ensuring a successful visit.
MULFORD